

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Person to Contact: [REDACTED]

Telephone Number: [REDACTED]

Refer Reply to: [REDACTED]

Date:

Employer Identification Number: [REDACTED]
Key District Office: Baltimore

Dear Applicant:

This is an initial adverse ruling on your application for exemption from federal income tax under section 501(c)(4) of the Internal Revenue Code. The reasons for this ruling are explained below.

You were incorporated on [REDACTED] under the nonprofit laws of the State of [REDACTED]. Your creation was initiated by [REDACTED] and the physicians associated with the former [REDACTED].

[REDACTED] was formed pursuant to a consolidation and reorganization of [REDACTED]. Services of the two former hospitals are currently carried on by [REDACTED], whose sole member is [REDACTED].

[REDACTED] has been recognized as an organization described in section 501(c)(3) of the Code and has been excepted from private foundation status under section 509(a)(3).

[REDACTED] has been recognized as an organization described in section 501(c)(3) of the Code and has been excepted from private foundation status under sections 509(a)(1) and 170(b)(1)(A)(iii).

You are a membership organization with two classes of membership, the hospital class and the physician class. Article II, Section 2.1(a) of your bylaws provides that [REDACTED] is the only member of the hospital class. Section 2.1(b) provides that the physician class consists of licensed physicians who are members of the medical staff at [REDACTED]. Membership in the physician class is also available to dentists and podiatrists.

[REDACTED]

Your purpose, as stated in your Articles of Incorporation, is to promote the common good and general welfare of the community by facilitating the efficient and cost-effective delivery of hospital, physician and other health care services.

You represent that you were formed as part of an effort to contain overall health care costs and form a vehicle for the required participation in a system of managed competition. You indicate that together your members will develop a vertically integrated health care delivery system that will promote access, quality of care and efficiency in the [REDACTED] community.

You indicate that the [REDACTED] community will benefit from enhanced access, in the most cost-effective manner possible, to a full range of hospital inpatient, outpatient, and physician services. Moreover, you state that this enhanced accessibility will be provided at a lower cost to the patient and to the overall community.

Your primary activity will be to contract with third-party payors on behalf of your members. In addition, you plan to educate your physician members with respect to managing patient care more effectively. This will include the profiling of individual physicians' practices and the careful review of data on utilization, costs, charges, patient outcomes, patient satisfaction, etc. Through this process, you represent that you will have a positive impact on the quality of care rendered to patients of your members while lowering overall health care costs.

You plan to contain overall health care costs by implementing, over the next three years, a system of capitation payments with regard to your member health care providers. Over the next several months, while the system is being phased in, you anticipate that third-party payors will pay primary care physicians on a capitated basis, specialty physicians on a fee schedule basis and [REDACTED] on a negotiated per diem basis. You expect to accomplish full risk contracting by your members by [REDACTED]. You represent that such a system will provide strong financial incentives to reduce the per capita utilization of services as member health care providers will be receiving only a fixed amount per patient from the third-party payors.

[REDACTED]

In addition to overall cost containment, you represent that you will facilitate direct cost savings to patients in the community through your exclusive contractual relationship with an existing nonprofit health maintenance organization (the "HMO"). Pursuant to that contract, your members provide services to members of the [REDACTED] community who are enrollees of the HMO. You state that this relationship brings all of the demonstrated cost savings of HMOs to the patients served by your members pursuant to this contractual relationship.

You indicate that through your relationship with the HMO, you will participate actively with the HMO in rendering services to the elderly, specifically to Medicare beneficiaries without the need for costly supplemental coverage.

You represent that your members currently render services to [REDACTED] (Medicaid) patients.

You indicate that you anticipate participating with the HMO in ongoing statewide initiatives to render comprehensive coverage to Medicaid patients across the State.

You anticipate that your members will engage in various forms of community service, including community health fairs, health screenings, patient education, seminars and other forms of community outreach, at no cost to the community.

You assert that there will be no economic advantage conferred upon your members as a result of your activities. You anticipate that per capita utilization of hospital and physician services will decrease and per capita reimbursement levels from the HMO to your physician members will likely decrease. You indicate that due to the move to capitation payment, there will be strong financial incentives for both your hospital and physician members to reduce utilization and unnecessary care.

Article II, Section 2.1(a) of your bylaws provides that hospital membership is limited to one member, [REDACTED]. Section 2.1(b) states that physician membership is limited to physicians on the medical staff of [REDACTED]. Physician membership is further limited by that section of your bylaws to physicians who are not employed by a competitive hospital or health care system. You reserve the right to waive such restriction if it is deemed by you to be in your best interest.

[REDACTED]

Article II, Section 2.4(g) of your bylaws indicates that employment by a competitive hospital or health care system is cause for termination of physician membership.

Each of your members is entitled to one vote. The presence of an authorized representative of the hospital member and the presence of a majority of all physician members entitled to vote constitutes a quorum at meetings. The affirmative vote of the hospital member and a majority of the votes of all physician members is necessary for the adoption of any matter voted upon other than the election of your board of directors.

Currently, you are controlled by an eighteen member board of directors. You state that five of your directors are also directors of [REDACTED] and that four of those same five directors are also directors of [REDACTED]. You indicate that two of your four officers are also officers of [REDACTED] and [REDACTED].

You represent that these directors will serve for one year. Thereafter, you indicate that you will comply with Article III, Section 3.2 of your bylaws which provides that you shall have twelve directors. That section states that your hospital member shall appoint six of those directors and the remaining six directors shall be elected by the physician members.

Your primary source of support will be payments made to you by third-party payors with respect to services performed by your hospital and physician members.

In addition to payments by third-party payors, you will receive dues and capital contributions from your members. Each physician member pays \$[REDACTED] in dues. Your hospital member, [REDACTED], pays dues equal to the aggregate amount of all dues paid by your physician members. Members will also be required to make capital contributions in an amount to be determined by your board of directors.

You will receive payment for medical services provided by your members to enrollees of third-party payors and self-insured employers. The fees for medical services will be pre-set in accordance with agreements with third party payors and self-insured employers. In turn, you will pay your members a set fee for the services performed.

Section 501(a) of the Code exempts from federal income tax, among others, organizations described in section 501(c)(4). Section 501(c)(4) includes civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

Section 1.501(c)(4)-1(a)(2)(i) of the Income Tax Regulations provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the community. An organization embraced within this section is one that is operated primarily for the purpose of bringing about civic betterment and social improvements.

The determination of whether an organization qualifies for exemption from federal income tax under section 501(c)(4) of the Code is essentially a factual question. If an organization is used to channel private economic benefits to its members the organization is not exempt under section 501(c)(4).

Contracting Plumbers Cooperative Restoration Corporation v. United States, 488 F.2d 684, 686 (2d Cir. 1973), cert. denied, 419 U.S. 827 (1974) describes an organization whose sole purpose is to insure the efficient repair of "cuts" made in the streets of New York City by the organization's members in the course of their plumbing activities. Prior to the organization's formation, city employees had repaired such cuts, billing the responsible plumber accordingly. This municipal restoration program was highly inefficient, subjecting the community to the dangers of -- and the plumbers to the corresponding liability for -- improperly filled excavations for prolonged periods. Moreover, this inefficient program was resulting in a large annual operating loss to the city.

After negotiating with the city, the plumbers were authorized to conduct their own restoration program through the organization, a non-profit cooperative. The organization performed efficiently; the average restoration time was reduced to approximately fourteen days and the organization was able to turn a modest profit.

Relying on the organization's nonprofit nature, its public origins, and its undisputed benefit to the residents of the city, the district court held that the organization was exempt as an organization described in section 501(c)(4) of the Code. The court found that the organization's value to the community and to its individual members was "indistinguishable."

[REDACTED]

The court of appeals disagreed. Among the factors considered by the court of appeals was the fact that the organization did not repair the equally troublesome potholes left by the few remaining nonmember plumbers or the other, more numerous enterprises that burrow into the city streets. Additionally, the members of the organization enjoy the economic benefits precisely to the extent that they use, and pay for, its restoration services. The court felt that this conditional benefit most distinguished Contracting Plumbers from Monterey Public Parking Corporation v. United States, 321 F.Supp. 972, aff'd, 481 F.2d 175. In Monterey, the court held that a private non-profit parking lot financed by local merchants was exempt under section 501(c)(4) of the Code -- but only because its organizers had not exploited the facility by giving themselves special advertising rights, or by restricting the validation stamp system to certain businesses. The court recognized that such limitation would have demonstrated that the merchants "were in fact primarily interested in their own ends rather than those of the public."

In Contracting Plumbers, the court of appeals found that the organization provided substantial and different benefits to both the public and its plumber members. Thus, it held that the organization was not primarily devoted to the common good as required by section 501(c)(4).

Revenue Ruling 86-98, 1986-2 C.B. 74, describes an individual practice association ("M") formed to provide health services through written agreements negotiated with health maintenance organizations ("HMOs").

M's membership is limited to licensed physicians who are engaged in the active practice of medicine and who are members of a specified county medical society. The activities of M are managed by an executive committee which is elected by the membership of M. The bylaws of M require that a majority of the executive committee be members of M.

M's primary activities are to serve as a bargaining agent for its members in dealing with HMOs, and to perform the administrative claims services required by the agreements negotiated with the HMOs. M is paid a capitation amount by each HMO based on the number of HMO subscribers entitled to receive medical services. Members bill M for services rendered to the HMO subscribers and accept claims payments for M as payment for services rendered.

[REDACTED]

M's income is derived from its contracts with HMOs and its expenditures are for administrative costs and payments to its members.

The main functions of M are to provide an available pool of physicians who will abide by its fee schedule when rendering medical services to the subscribers of an HMO, and to provide M's members with access to a large group of patients, the HMO subscribers, who generally may not be referred to nonmember-physicians. M negotiates contracts on behalf of its members with various HMOs, administers the claims received from its members, and pays them according to its reimbursement agreement.

Revenue Ruling 86-98 states that these facts indicate that M is akin to a billing and collection service and a collective bargaining representative negotiating on behalf of its member-physicians with HMOs. In addition M does not provide to HMO patients access to medical care which would not have been available but for the establishment of M.

Thus, the revenue ruling holds that M operates in a manner similar to organizations carried on for profit, and its primary beneficiaries are its physician members rather than the community as a whole. Therefore, M does not qualify for exemption from federal income tax as a social welfare organization under section 501(c)(4) of the Code.

You state that you anticipate that your members will engage in various forms of community service, described above. There is nothing in the file to indicate that these activities were initiated by you or that you will have any direct control or involvement with respect to these activities. It appears that your members will be carrying on these activities on their own behalf.

You represent that your members currently render services to [REDACTED] ("Medicaid") patients. You do not indicate whether your members rendered services to Medicaid beneficiaries prior to joining your organization. In addition, there is no indication in your bylaws that participation in Medicaid is required for membership in your organization. Further, you do not indicate whether the services provided by your members to the Medicaid beneficiaries through the contracts you negotiate constitute a substantial part of your activities.

[REDACTED]

You are similar to the organization described in Consumer-Farmer Milk Cooperative in that you are controlled by your membership, all but one of your members are physicians operating on a for-profit basis and your activities confer an economic advantage on your members.

Like the organization described in Contracting Plumbers, the fact that you limit your membership to members of the medical staff of [REDACTED] who are not employed by a competitive hospital or health care system clearly indicates that your primary purpose is not to work for the common good of the community but rather to provide access to an expanded patient base for [REDACTED] and physicians who choose to affiliate themselves with and maintain economic loyalty to [REDACTED].

You are essentially an independent practice association like the one described in Revenue Ruling 86-98, above, with the addition of a hospital participant. You provide no health care services. Your membership is limited to [REDACTED] and physicians who are affiliated with and economically loyal to [REDACTED], but who remain engaged in the private, for-profit practice of medicine. You act as a bargaining agent for these physicians in negotiating managed care contracts with HMOs and self-insured employers. The direct benefits of your activities thus flow to private individuals engaged in the for-profit practice of medicine rather than to the community as a whole. Therefore, you are not operated primarily for the promotion of social welfare. Accordingly, we have concluded that you are not exempt from federal income tax under section 501(c)(4) of the Code.

You have a right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views with a full explanation of your reasoning. This statement, signed by one of your principal officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. If you want a conference, you must request it when you file your protest statement. If you are to be represented by someone who is not one of your officers, he/she must file a proper power of attorney and otherwise qualify under our Conference and Practice Requirements.

You will expedite our receipt of your protest statement by using the following address on the envelope: Internal Revenue Service, [REDACTED], [REDACTED], 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

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Date 2/13/95

Surname [REDACTED]

2/23/95

If we do not hear from you within 30 days, this proposed ruling will become final. Copies of this letter will then be forwarded to the District Director, Baltimore, which is your key district for exempt organizations matters. Thereafter, any questions about your federal income tax status or the filing of tax returns should be addressed to the District Director of Internal Revenue Service.

Sincerely yours,

[REDACTED]
Chief, Exempt Organizations
Rulings Branch 1

cc: [REDACTED]

Code	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Reviewer	Reviewer
Surname	[REDACTED]	[REDACTED]					
Date	10/17/94	10/21/94					